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FM AMEMBASSY KUALA LUMPUR
TO RUEHC/SECSTATE WASHDC 6730
INFO RUCNASE/ASEAN MEMBER COLLECTIVE
RUEHBJ/AMEMBASSY BEIJING 2111
RUEHKO/AMEMBASSY TOKYO 2185
RUEHRL/AMEMBASSY BERLIN 0137
RUEHFT/AMCONSUL FRANKFURT 0065
RUEHFR/AMEMBASSY PARIS 0147
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEHGV/USMISSION GENEVA 1389

UNCLAS SECTION 01 OF 05 KUALA LUMPUR 000959

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E.O. 12958: N/A
TAGS: ETRD EINV EFIN PREL MY
SUBJECT: MALAYSIA'S "NEW" AUTO POLICY: A STEP TOWARDS LIBERALIZATION

Sensitive But Unclassified - Not for Internet Distribution

Ref: 2005 KUALA LUMPUR 4080

Summary
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¶1. (U) The Malaysian government issued its new National Auto Policy (NAP) on March 22, 2006, following up on the NAP Framework issued five months earlier (reftel). The NAP envisions some significant changes to development of Malaysia's auto sector, including an expiration date for its longstanding (and much criticized) approved permit (AP) system, a revised customs valuation regime designed to more accurately assess import values, and a ban on most used car imports. Key changes to the tax structure include a significant decrease in excise duties and an immediate lowering of import duties for vehicles from Malaysia's ASEAN partners, bringing Malaysia in line with the ASEAN FTA (AFTA) earlier than expected. Malaysian officials acknowledge, however, that the NAP remains a work in progress and that many details remain unsettled.

¶2. (SBU) Car dealers took advantage of the NAP by lowering prices, though their reductions were due in part to pressure from the government. In addition to reiterating five key goals from last year's framework, the NAP includes a sixth goal to safeguard consumer interests. While the NAP moves the auto sector towards liberalization, the new policy makes clear that the government intends to protect "national" cars, including the troubled Proton. Still Malaysia's dominant carmaker, Proton continues to explore alliances with foreign automakers that would give it access to improved technology and, perhaps, more export markets. U.S. and other carmakers have been meeting with government officials on implementing the NAP. They generally welcome the NAP, but hope that an FTA with Malaysia would produce faster and deeper reforms, including import duties for U.S. vehicles that are no

higher than those imposed on ASEAN-origin cars, and an earlier abolition of the AP system than the NAP envisions. End summary.

The Government's Current Vision
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¶3. (U) Malaysia's New Auto Policy envisions the continued dominance of two strong national auto manufacturers (Proton and Perodua), but also recognizes the important role that foreign manufacturers play in the Malaysian auto sector. The NAP encourages foreign firms to maximize joint ventures with local partners, and to upscale their assembly operations into niche areas where Proton and Perodua have little interest. The new policy also encourages consolidation within the auto components sector to create stronger domestic firms that would be better able to compete for contracts in the global automotive industry.

Approved Permits - An Expiration Date
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¶4. (U) The NAP calls for elimination of the AP system by December 31, 2010, which would end one of Malaysia's high profile preference programs for ethnic Malays. A spokesman for the Prime Minister has stated that APs would be made available in the meantime based on the contribution made to the local economy. Priority would be given to manufacturers that have committed to a significant increase in production volume in a particular model, with plans for significant exports of that model, which then seek APs to import other models to complete their product range in the Malaysian



market. The spokesman added that a limited number of APs would also be made available based on the need to ensure sufficient vehicle choice for consumers. These criteria make no mention of reserving APs for ethnic Malays (Bumiputera), leading some analysts to speculate that the NAP may for the first time give non-Malays the ability to obtain APs.

¶5. (SBU) Comment: The setting of a date for the elimination of the AP system is testimony to the increasingly negative public opinion it has engendered in recent years, even among prominent ethnic Malays. Many high profile Malaysians, including former PM Mahathir, now criticize the AP system as inimical to its original goal of giving entrepreneurial Malaysians greater access to a lucrative sector. Instead, the system has become a means for a very small group of connected Malays to enrich themselves with minimal effort, while contributing to the high costs of imported vehicles. End comment.

Motor Vehicle Tax Structure Changes Yet Again
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¶6. (U) The NAP reduces further the excise tax reductions for passenger cars that came into effect in conjunction with the NAP framework in October 2005. The new excise duties, effective March 22, 2006, now range from 75 to 125 percent. Although these constitute reductions of between 16 and 69 percent (depending on the engine size), these new rates are still higher than those in effect until December 2004. Nevertheless, most auto manufacturers here, including Ford Malaysia and Daimler Chrysler Malaysia, used the new excise rates as a marketing tool, and announced an immediate reduction in prices for completely knocked down (CKD) models of up to 11 percent.

¶7. (U) Of more concern to national carmakers like Proton and Perodua was the government's decision to

reduce immediately the import duties for ASEAN-origin completely built up (CBU) vehicles from fifteen to five percent. This reduction, along with the elimination of the AP system, is perhaps the most far-reaching step implemented by the NAP. Malaysia's commitments under the ASEAN FTA (AFTA) did not require it to lower these duties until 2008. By acting now Malaysia has eliminated a contentious issue with its ASEAN partners. The government is hopeful that the step will promote greater integration within ASEAN. Imports from the rest of ASEAN will still be limited until the AP system is abolished, however. There is no change to the MFN import duty of 30 percent for non-ASEAN CBU vehicles, giving ASEAN imports a marked advantage over imports from the rest of the world, including the U.S. Prior to the series of tax structure changes initiated in December 2004, both ASEAN and non-ASEAN CBU imports were assessed similar import duties.

¶8. (U) Proton and Perodua now face the near elimination of the import duties (on ASEAN-origin vehicles) that were the prime means of protection for both companies. Senior GOM officials, including Finance Minister (II) Nor Mohamed Yakcop, were quick to criticize both firms for not reacting quickly to the increased competition from imported (CBU) models due to the lower import duties. Though they initially announced only modest discounts of two to four percent on most of their models, both companies quickly gave in to the political pressure by increasing their discounts substantially.

## Effective Valuation of Car Imports

¶9. (SBU) Despite losing the protection of high import duties, national carmakers should benefit from another NAP reform designed to assess a more accurate value on



CBU imports in order to determine customs duties. Under the new policy, the government gazette will publish the values of imported CBU cars as determined by a government committee, using Singapore CIF values and market studies that include back calculation from retail prices. By steering away from prior importer declared values, the government hopes to significantly cut the incidence of tax under-declaration. One study suggests that most CBU imports would increase in price from 10 to 40 percent, given the widespread under-declaration of vehicle values.

¶10. (U) If this new provision is enforced it should decrease CBU demand and increase the attractiveness of Malaysian-built cars, either by the national carmakers or by imported CKD models. The new provision would also help level the playing field for importers that do not abuse the current system, such as U.S. firms. Demand for such cars should also be stimulated by another NAP provision that phases out most used-car imports by 2010.

## Dreaming of a Regional Auto Hub

¶11. (U) One of the six broad goals of the NAP is to develop a regional automotive manufacturing hub in Malaysia. Bringing Malaysia's import duty in line with the rest of ASEAN is one means of stimulating the development of such a hub, by easing Malaysia's ability to export within ASEAN with few tariff barriers. The government will also nurture such a hub by using its licensing authority to control the development of new foreign manufacturing facilities. Under the NAP new manufacturing licenses would not be issued until after domestic over-capacity had been resolved. The NAP also prohibits current excess capacity being used to

assemble new makes or models that compete directly with those produced by national car manufacturers.

¶12. (U) Just days after announcing the NAP, however, Malaysia demonstrated that its overall goal of creating a regional auto manufacturing hub trumped its over-capacity concerns. On March 29 Chinese automobile manufacturer Geely announced that it would open an assembly plant in Malaysia to produce two low cost models, 80 percent of which were destined for export. Geely reportedly will become the first Chinese auto company to assemble vehicles overseas. Malaysian approval of this new manufacturing capacity, producing models that would seem perfect competitors to Proton, reportedly was forthcoming only through Geely's commitment to export most of its production.

## The Future of Proton

¶13. (U) Proton's future as Malaysia's dominant "national" carmaker remains uncertain. Automobile sector analysts here agree Proton needs to conclude an alliance with a foreign partner that can provide significant technology and marketing expertise to enable Proton to remain competitive domestically. Proton's lengthy courtship with Volkswagen ended abruptly in early 2006 when VW pulled out of talks to form an alliance, apparently unhappy with Proton's reluctance to give VW an equity stake. The two companies continued lower-profile cooperation, including the supply by VW to Proton of a limited number of components. Press reports indicate the two companies recently have resumed high-level negotiations on forming an alliance that would create a separate corporate entity to produce Proton-branded cars, based on VW platforms, for sale throughout ASEAN and India. In the meantime VW has decided to enter the Malaysian market in full force, with plans to introduce nine new models here and to establish twelve new dealerships



over the next two years. If it does not end up in alliance with Proton, VW could become another significant competitor.

¶14. (U) Proton also reportedly is in talks with both French carmaker Peugeot Citroen, and with its old partner Mitsubishi, which previously played a big role in Proton's development. In both cases Proton is believed to be seeking looser, more technical alliances than it had contemplated with VW. These types of alliances would be more politically palatable in Malaysia as they would involve little, if any, equity sharing. But some analysts believe Proton can only be saved through a deeper alliance, which would provide Proton with economies of scale, access to advanced technologies, and connections to an established global distribution and supply network. VW or another foreign partner likely would not be willing to provide such substantial benefits without a significant equity share in Proton.

¶15. (U) The NAP makes clear that Malaysia is not ready to abandon the concept of a national car. Even Malaysia's top leaders acknowledge that change is necessary, however. Deputy Prime Minister Najib Rezak said on May 23 that further government support for national carmakers would be "targeted, finite and transitional, not open-ended and unconditional," and added that these firms would never be able to offer a full line up of vehicles to satisfy all segments of the market. Although Najib stressed that Proton needs a strong foreign partner, especially to give the firm a decent shot at competing abroad, and said that the firm would allow the foreign firm to take an equity stake in

Proton, he also noted that the GOM would not permit a foreign firm to take a controlling interest in the company.

¶16. (U) Proton's new president, Syed Zainal, has commented the company welcomes the competition that will be created by the NAP. He admitted that Proton needs to become a true competitor to foreign manufacturers, and reportedly commented that Proton "cannot be a national car forever." Tengku Mahaleel, who was pushed out as Proton CEO last year after more than a decade on the job, reportedly has expressed doubts about the NAP's ability to reach its goals, in particular Malaysia's hope to become a regional manufacturing hub. Although Mahaleel praised the government's goals, he observed that Malaysia's past implementation of auto sector policy was lackluster and incomplete. He pointed in particular to previous industrial master plans over the last two decades, which he claimed contained similar auto sector goals that were never realized. Mahaleel also blamed Proton's ills in part on Malaysia's banks, deriding their long-term, low-interest loans as depressing new car sales, since car resale values drop below outstanding loan balances well before the loans are paid off. Such loans have been key to Malaysians' ability to purchase imported cars rather than the (generally cheaper) national cars. (Rising interest rates in the last four months have curbed demand somewhat, with new auto sales in 2006 expected to grow at their slowest rate in three years.)

The Auto Sector and the FTA
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¶17. (SBU) U.S. auto industry representatives in Malaysia generally are satisfied with the direction of GOM policy on auto sector liberalization. However, they have identified several areas for U.S. trade officials to focus on during the FTA negotiations. The significant difference in import duties for ASEAN-origin CBU vehicles compared to non-ASEAN imports is a prime concern. U.S. firms seek an agreement containing



import duties on U.S. CBU vehicles that are no higher than those Malaysia imposes on similar ASEAN-origin imports. U.S. firms also are concerned about the government's new policy on determining the import values for CBU vehicles. Although the new valuation guidelines should have little impact on law-abiding importers, U.S. automakers have identified this provision as non-compliant with the WTO, and have indicated that they will ask U.S. trade negotiators to push Malaysia to accept franchise importer declarations of commercial value for taxation purposes.

¶18. (SBU) U.S. carmakers welcome the government's efforts to create a more transparent AP system that would allow the firms' Malaysian partners to directly obtain APs, and substantially eliminate the role of other rent-seeking intermediaries in importing cars. Nevertheless, U.S. firms continue to complain that the AP system creates unnecessary costs that disadvantage imported vehicles, and that it also continues to impose a quota on imported cars. Given that the AP policy does not appear to be WTO-compliant, U.S. firms will push for an FTA that would accelerate the complete phase-out of APs earlier than 2010.

¶19. (SBU) Ford's senior representative here tells us that government officials have admitted that the NAP needs to be fleshed out significantly. He is pleased that the government is consulting more with industry as the NAP moves forward, but he also noted that GOM officials have indicated there will be still more

changes to the auto policy. The government has indicated that its early priorities will be implementing the provisions related to customs valuation of imports, and the abolition of used car imports. The government reportedly has given overall responsibility for implementing the NAP to the Malaysian Industrial Development Authority (MIDA), the government's investment promotion agency.

Comment
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¶20. (SBU) Like the framework issued last fall, the National Auto Policy is short on details. An accurate assessment of its effectiveness in genuinely opening up the auto sector to broad competition may not be possible for many months, if not years. The reportedly enhanced role for MIDA in implementing the NAP is encouraging, given that agency's pro-foreign investment outlook. It's also a bit surprising, since MIDA is an arm of the Ministry of International Trade and Industry (MITI), which was discredited by scandal last year over the misallocation of APs, to the point that the ministry was even stripped of its authority to issue APs.

¶21. (SBU) Malaysia's commitment to reform may be tested soon, as some auto analysts here predict a contraction of the market, with sales declining by as much as ten percent in 2006 compared to 2005. Demand has been over fulfilled in recent years, but increasing interest rates are making long-term loans less attractive. The lower end models of both Proton and Perodua may benefit from this changing market, while expensive imported cars could suffer declining market shares. Strengthened national carmakers could encourage the government to maintain its commitment to reform. If Proton's share of the market were to continue to diminish significantly, however, the GOM could be expected to seek yet more changes to the NAP to help preserve the company's viability. In such a scenario the challenge would be for the government to maintain its commitments under the AFTA and, eventually, under a potential U.S.-Malaysia FTA.

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